INSTITUT C.D. HOWE INSTITUTE

COMMENTARY
NO. 399

Equipping Canadians for Success: A Shadow Budget for 2014

Firm containment of federal employment costs can achieve an early and durable budget surplus, and set the stage for measures to enhance opportunities for Canadian workers, promote saving and investment, and foster innovation.

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Commentary No. 399
January 2014
Fiscal Policy

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Vice-President, Research

$12.00
ISBN 978-0-88806-920-7
ISSN 0824-8001 (print);
ISSN 1703-0765 (online)

The Study In Brief

The 2014 edition of the C.D. Howe Institute's annual Shadow Federal Budget reinforces Ottawa's near-term focus on returning to budgetary surplus, and presents a number of measures to foster growth in living standards over the longer term.

Prudent forecasting and greater transparency in budgeting and government spending are two elements of the plan to achieve an early and durable surplus. Spending control is the third – with the dominant thrust being containing the cost of federal employment, and in particular the costs to taxpayers of federal pensions and other postretirement benefits. The Shadow Budget estimates that caps on taxpayers' contributions to federal-employee pensions, the termination of indefinite banking of unused sick days, and a move to 50-50 cost-sharing of post-retirement health benefits can reduce federal spending by some $5.2 billion in fiscal years 2014/15 and 2015/16 alone.

Shadow Budget measures to equip Canadians for success in the longer term fall under three broad headings: the skills of, and opportunities for, Canadian workers; saving and investment; and innovation and entrepreneurship.

Measures to promote skills and opportunities include reducing the pressure of the federal government on Canadian labour markets, investing in new job-information and matching, shifting the tax base from income to consumption taxes, phasing out regionally differentiated Employment Insurance, and promoting longer worklife by increasing the age at which Canadians lose access to tax-deferred saving.

The Shadow Budget contains several measures to improve the treatment of saving, and savings, in tax-deferred vehicles. It also proposes to promote investment by providing more uniform tax treatment of active foreign-investment income, and a regular rolling review of capital-consumption allowances.

As for innovation and entrepreneurship, the Shadow Budget proposes a more favourable tax regime for intellectual property income and making academic excellence the key criterion in supporting basic research. It would reduce ongoing support to many Crown corporations, prepare a slimmed-down Canada Post for a competitive mail market, and create more market discipline for Crown lenders. It would also reduce tariffs, and create a more transparent system for reporting, reviewing and reducing tax expenditures that substitute for formal spending programs.

The 2014 Shadow Budget builds on Canada's relatively good post-crisis performance. It reinforces progress toward surpluses, and so protects Canadians from higher interest rates and reduces the claims of government borrowing on Canadian saving. And it supports economic growth with measures to better deploy Canada's human capital, promote investment, and stimulate income-boosting innovation. In short, it provides the kind of fiscal leadership Canadians need from their federal government.

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While economic performance worldwide and in Canada continues to disappoint, relatively favourable circumstances and policies position Canada well to return to budget balance in the short term, and promote economic growth in the longer term.

1 Overview

This Shadow Budget will pursue the return to federal budgetary surplus anticipated in the federal government's 2013 Economic and Fiscal Update (Fall Update). A return to surplus will be good news for Canadians. Debt paydown will protect Canadian taxpayers from higher interest charges, whether sparked by financial turbulence or simply the gradual return of world interest rates to more normal levels. The end of chronic federal government borrowing will boost confidence and support lower interest rates, alleviating the threat of government competing with the private sector for investable funds, freeing up resources for capital investments and benefiting households struggling with record debt levels. More robust government finances will also help Canadians deal with the pressures of population aging on government finances, especially the crunch on provincial governments, whose level of fiscal preparation is grossly inadequate (Busby and Robson 2013a).

To ensure that the federal government achieves surplus and that the improvement in its fiscal position is durable, this Shadow Budget builds on the progress made in the last three federal budgets to end stimulus spending and put the cost of government operations on a more sustainable path. It also takes steps to make federal fiscal policy more transparent: making the true cost of government operations and tax/transfer policy clearer to Canadians will help ensure value for money for Canadian taxpayers in the future.

The expected near-term return to balanced budgets permits a longer-term focus on growth-fostering fiscal and structural policies that will pay dividends for decades to come. The skills and efforts of Canada's workers and the opportunities available to them to deploy their talents are core drivers of economic performance. This Shadow Budget takes several steps to improve the outlook for Canada's human capital, the tools and equipment at their disposal, and the new technology and ideas that spur innovation.

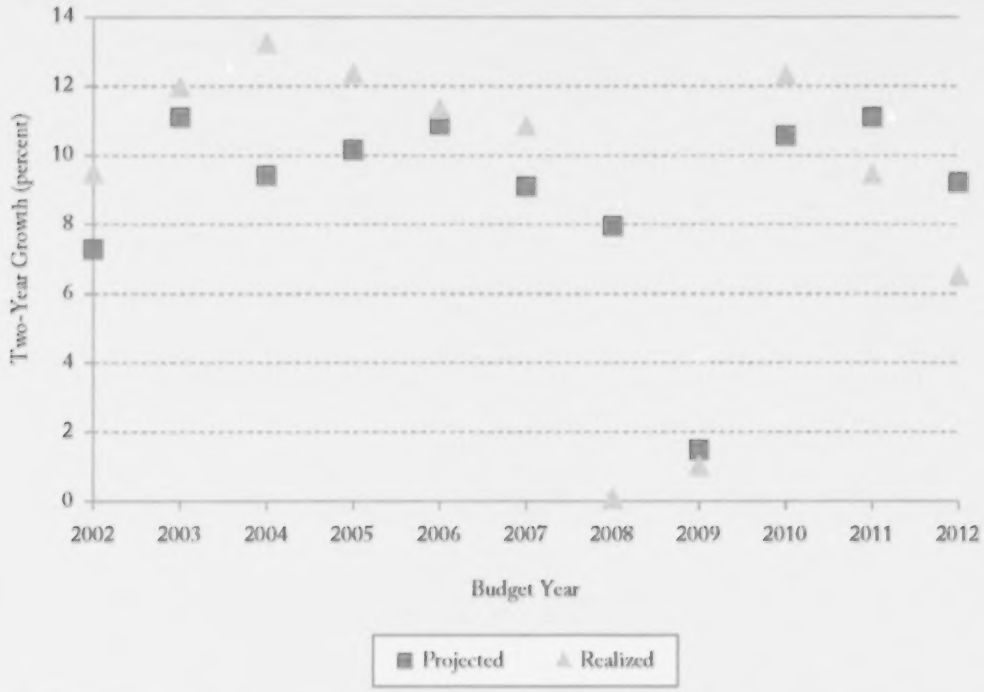
Keeping Canada's living standards in the front rank of advanced economies requires growth-oriented fiscal policies adapted to current economic challenges, including: demographic aging that is pushing labour force growth down and healthcare spending up; lower interest rates and investment returns than recorded in previous decades; and a changing global environment for Canadian exports.

2 Prudent Fiscal Management

Prudent fiscal management has three main elements: (i) conservatism in the baseline economic and fiscal projections, (ii) financial reporting that allows members of Parliament and Canadians generally to better understand federal finances and respond to

The authors thank the members of C.D. Howe Institute's Fiscal and Tax Competitiveness Council for their comments and suggestions on previous drafts.

Figure 1: The Tendency for Growth Forecasts to Underestimate Economic Cycles
Nominal GDP Growth Projections in Budgets Compared to Realizations, 2002 to 2012



Sources: Federal budgets, various years; authors' calculations.

developments, and (iii) rigorous control of costs in government operations.

2.1 Prudent Projections

As in past years, this Shadow Budget uses as its foundation projections from the most recent federal Fall Update (Canada 2013) – projections that reflect input from leading private sector forecasters. Because economic models tend toward equilibrium, these forecasts tend to underestimate growth during booms and overestimate it during busts. (Figure 1 compares budget forecasts for nominal GDP growth over two years with actual outcomes.)

Actual growth exceeded forecasts in the six budgets prior to the 2008 recession, and fell short of them in all but one budget since then.

This pattern has some offsetting consequences for budgetary planning, since interest rates and therefore debt-servicing costs tend to be higher in booms, and lower in busts (Laurin and Robson 2013). The possibility that the economy will again disappoint in the near term nevertheless argues for prudence. So this Shadow Budget continues the recent inclusion of a $20-billion downward adjustment to the private-sector forecast for nominal GDP. This adjustment provides a $3-billion contingency buffer to fiscal revenues in each year (Table 1).

Table 1: Assumptions and Projections, 2013/14 to 2015/16[a]

	2013/14	2014/15	2015/16
	($ billion except as noted)		
Economic Growth (*Percent*)			
Real GDP Growth	1.7	2.4	2.6
GDP inflation	1.3	1.8	2.0
Nominal GDP Growth	3.0	4.2	4.6
Federal Revenues			
Taxes on Incomes, Payroll, Consumption and Other Transactions	239.3	253.1	266.7
User Fees and Charges for Government Services and Products[b]	15.0	14.8	17.6
Investment Income[c]	12.4	12.5	12.6
Total Revenues	**266.7**	**280.4**	**296.9**
Federal Expenditures			
Direct Program Expenses	120.7	115.4	115.9
Transfers to Persons and Governments	132.9	137.7	143.5
Gross Debt Charges	29.5	29.7	30.8
Total Expenditures	**283.1**	**282.8**	**290.2**
Fiscal Prudence			
Provision for Prudence	-1.5	-3.0	-3.0
Summary of Federal Revenue, Expenditure and Balance			
Taxes, Fees, and Other Charges	254.3	267.9	284.3
Program Spending and Transfers	-253.6	-253.1	-259.4
Debt Charges Net of Investment Income	-17.1	-17.2	-18.2
Adjustment for Fiscal Prudence	-1.5	-3.0	-3.0
Budgetary Balance Adjusted for Fiscal Prudence	**-17.9**	**-5.5**	**3.7**

Notes:
(a) Based on Fall Update (Canada 2013).
(b) Estimated figures including earnings of consolidated Crown corporations.
(c) Estimated figures including interest income, net income from enterprise Crown corporations, foreign exchange revenues, and other returns on investment.

Sources: Canada (2013); authors' calculations.

The Shadow Budget baseline does assume that the round of operating budget freezes announced in the Fall Update will succeed. While such an assumption might appear ambitious rather than strictly prudent, recent restraint has reduced Ottawa's non-transfer spending, with operations, including the bill for federal employee's current and deferred compensation, being the main focus. This record shows that the return to budget surplus by 2015/16 is achievable, and is also a useful foundation for further measures.

2.2 Better Transparency

While the bottom-line results show success in cost constraint, the specific cost-cutting actions and initiatives undertaken by government departments have been difficult for outside observers to identify. Parliamentarians also do not receive information on government spending that is easy to understand and reconcile with budget projections or the Public Accounts released after year-end. More transparency and disclosure would facilitate tracking of progress and improve the credibility of the current cost-cutting exercise.

A key step toward better disclosure is reform of the *Main Estimates* and *Supplementary Estimates* of spending voted by Parliament. Traditionally, these documents – which are Parliament's main opportunity to scrutinize the government's spending plans – have been tabled after the budget. In recent years, however, the *Main Estimates* have often been tabled before the release of the budget, at least potentially rendering them obsolete at the outset. And while budgetary initiatives may be reflected in *Supplementary Estimates*, all these estimates use cash-based accounting. Cash accounting makes them non-comparable with the budgets and the Public Accounts: these documents anticipate, or report, revenues and expenditures during the period when the relevant activity is expected to occur, or occurred – far superior, for example, in spreading the cost of a long-lived asset over the period it will deliver its services instead of recording it all when the cash outlay occurs.

Presenting the main and supplementary estimates on the same accounting basis as the budget would improve transparency and understanding – vitally important for improving legislators' control of, and accountability for, adherence to budget targets (Busby and Robson 2013b). The government will therefore begin preparing the estimates on an accrual accounting basis in fiscal year 2014/15, and will further commit to presenting the federal budget ahead of the tabling of the *Main Estimates* in Parliament.

2.3 Better Transparency and Value for Money in Federal Government Operations

Rising employment costs help explain much of the rise in federal spending since the early 2000s. Reducing them is essential to the fiscal projections and the longer-term goal of providing good services at reasonable tax rates. Steps to further reduce compensation costs, and make those reductions durable are therefore a major focus of this Shadow Budget.

It addresses Ottawa's average cost of employing a full-time worker, which includes wages and salaries plus employer contributions to health, dental, sick leave accumulation, disability, workers' compensation, social security, pension, and other post-retirement benefits. The average cost of a full-time worker almost doubled between 2002/03 and 2012/13, from about $66,500 to $127,400 (Figure 2). Over the same period, business sector compensation per job in Canada rose only about a third, from about $38,600 to $52,100.

2.3.1 Wages, Salaries, and Current Benefits

Some of this growth differential occurred in base wages and current benefits: Ottawa's wages and benefits per employee grew by 3.5 percent per year on average over the period, compared to 3.0 percent in the business sector.

Latterly, spending restraint, including the operating budget freeze between 2009/10 and 2011/12, has contained growth of current salaries and benefits per employee. The average increase of 2.8 percent per year from 2010/11 to 2012/13 is much better than the average growth of 5.1 percent per year in the five years prior to the recession. The second-round operating budget freeze announced in the Fall Update should enable Ottawa to hold the growth of its wage bill to the expected rate of inflation of 2 percent per year – a small but realistic further improvement.

2.3.2 Post-retirement Benefits

Far more of the growth differential between federal and business-sector compensation is attributable to surging costs of pension and other post-retirement benefits. Ottawa's contributions as an employer to post-retirement benefits grew from 16 percent of wages, salaries, and benefits in 2002/03 to 24 percent 10 years later. Over that time, gradual recognition of changes in the value of assets and liabilities for future post-retirement benefits – related to plan amendments, declining interest rates and investment losses – boosted annual personnel expenses by an additional 21 percent of the wage and benefit bill by the end of that period. In total in 2012/13, expenses related to future post-retirement benefits of federal employees represented about 45 percent of wages, salaries and current benefits (Figure 2).

The rising reported cost of pensions and other post-retirement benefits is largely a consequence of a gradual recognition that the discount rates Ottawa has been using to value future payments have been too high. Bringing those discount rates down to more realistic levels has revealed the annual cost of new benefits as higher than it appeared. The same is true for the federal balance sheet. Lower discount rates increase the value of liabilities, leading to actuarial losses that, over time, appear as charges to taxpayers.

2.3.2.1 Pensions: Changes to the pension plans of federal employees and members of Parliament (MPs) in 2012 will gradually reduce Ottawa's share of their cost. Deductions from the paycheques of members of the Public Service (PS) plan – the largest federal-employee plan covering most non-uniformed employees – will rise from more than a third of the plan's reported cost last year to 50 percent by 2018 (OCA 2013a). Contributions by members of the Canadian Forces (CF) and Royal Canadian Mounted Police (RCMP) to their plans will rise from about 30 percent to about 45 percent of reported costs. Contributions by MPs will rise from a recent 15 percent in 2013 to half of reported cost by 2018 (OCA 2013b).

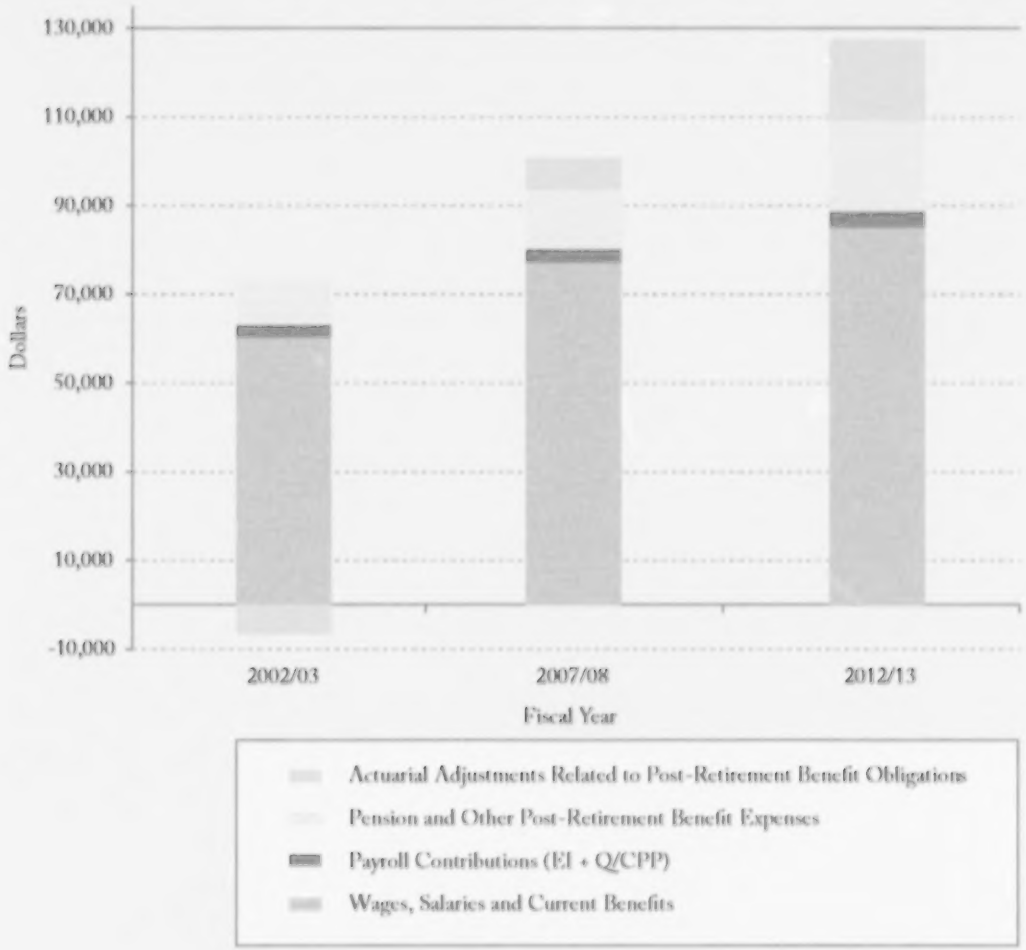
These changes will lower Ottawa's formal contributions to the PS plan for existing employees from 12.5 percent of pensionable pay in 2013 to 10.3 percent in 2018. Similarly, formal contributions to the RCMP plan will drop from 15.3 percent of pay in 2013 to 12.5 in 2018, and to the CF plan from 16.4 percent of pay in 2013 to about 12.6 in 2018. Recorded taxpayer contributions to the MPs plan will drop from a whopping 40.7 percent of remuneration in 2013 to 21.4 percent in 2018.

In addition, newly hired federal employees under the PS plan will have to wait five more years before being eligible to retire without penalty, which reduces the cost of pension accruals for these employees, and contributions by them and their employer. Ottawa's recorded pension contributions toward new hires will drop to 8.6 percent of pay by 2018, with matching contributions by employees.

Decreasing Ottawa's contributions to these plans is appropriate – indeed, this recommendation appeared in the C.D. Howe Institute's Shadow Budget for 2010. Reduced taxpayer contribution rates toward federal employee pension plans will lower the pressure on Ottawa's cost of personnel in the years ahead.

However, federal accounting badly understates the "current service costs," or annual funding requirements, that determine the amount to be split

Figure 2: Break-Down of Federal Personnel Expenses per Employee, 2002/03 to 2012/13



Sources: Public Accounts of Canada (various years); PBO (2012); authors' computations.

between Ottawa and employees. Notwithstanding the move to more realistic discount rates in valuing future payments, the federal government still understates their cost by using expected returns on a risky portfolio of assets. Yet the benefits are guaranteed by taxpayers, and the bulk of them are backed by no assets at all. As we have documented elsewhere (Laurin and Robson 2012; Robson 2012), a better valuation of these benefits is the amount someone not in a federal pension plans would need to fund a similar retirement – or alternatively to hedge against his/her liability for federal pensions as a taxpayer – by investing in the federal government's real return bonds (RRBs).

Table 2: Projected Current Service Cost and Taxpayer Share of the Cost for PS, RCMP, and CF Pension Plans, 2018

Pension Plan	Current Service Cost		Taxpayers Share of the Cost	
	Reported	Fair-Value	Reported	Fair-Value
	(percent of pensionable pay)		*(percent of current service cost)*	
Public Service (PS)	20.5	41.0	50.1	75.1
Royal Canadian Mounted Police (RCMP)	22.5	46.6	54.5	78.0
Canadian Forces (CF)	22.9	49.7	55.3	79.4

Notes: Contributions and current service costs for the PS Pension Plan are for employees hired before 2013. Fair-value refers to the cost of funding the pension obligations with the asset – the federal government's inflation-indexed bonds – that best matches the liability.

Sources: Authors' calculations based on OCA (2011, 2012, 2013a, and 2013c), and the RRB yield as of December 20th 2013.

Since the yield on RRBs is some 1.2 percent at the time of writing, as opposed to the 4.1 percent discount rate used by Ottawa, the fair value of Ottawa's pension benefits is still much higher than reported.[1] If accruing benefits in these plans were actually matched by additional RRBs, the costs for the PS, CF and RCMP plans in 2018 would range, not from the reported 20.5 to 22.9 percent of pensionable pay, but from 41.0 percent to 49.7 percent of pensionable pay (Table 2).

So in 2018, when the changes purport to have employees covering close to half of their pension costs, they will – if RRB yields stay where they are – only be covering about 25 percent of the plans' true annual costs. In addition, taxpayers will remain exposed to changes in the value of those benefits once they are earned – an exposure that valuing those benefits at realistic discount rates also reveals to be much larger than reported (Robson 2012). Taxpayers, themselves struggling with low rates of return as they save for their own retirements, and hampered by *Income Tax Act* limits on their own tax-deferred saving – 18 percent of pensionable earnings up to dollar amounts around $24,000 – are making a commitment to the future pensions of federal employees far greater than reported.[2]

1 Bond yields move all the time, reflecting changes in lending markets and expectations. Many people oppose marking pension liabilities to market using yields that fluctuate. However, the essence of defined-benefit plans is that they attempt to insulate participants from risk that their accrued benefits will change. Valuing liabilities at current yields lets sponsors and future participants understand more clearly the magnitude of the risk they bear as a result.

2 Even the understated current service costs reported by the government leads to total contributions to the pension funds above the limit of 18 percent of pay that applies to participants in defined-contribution pension plans and RRSP savers – a clear case of unequal treatment compared to non-federal employees.

This Shadow Budget proposes to limit taxpayers' exposure to pension shortfalls, and avoid subsidizing the accumulation of tax-sheltered pension funds at higher contribution rates than available to savers in RRSPs and DC plans. It introduces measures to cap Ottawa's contributions as an employer at 50 percent of the maximum tax-deferred limit available to Canadians saving in RRSPs or DC plans, or 9 percent of pensionable earnings. The rest of the amount needed to fund the plans at their actual current service cost would come from employees.

Taxpayers' contributions to the PS, RCMP, and CF pension plans are expected to be 12.3, 14.5, and 15.5 percent of pay, respectively, in 2014/15, and 11.7, 13.8, and 14.6 percent of pay, respectively, in 2015/16.[3] Total contributions to these plans will represent around $3.5 billion per year.[4] Reducing Ottawa's contributions to 9 percent of pay across the board would result in annual expense savings of about $1.1 billion in 2014/15 and $0.9 billion in 2015/16.

This shift in funding risk means that plan participants will have a greater stake in the sustainability of federal pension plans, and potential future changes – further increases in retirement age, for example. The government will therefore open discussions about how to create a shared-governance structure that builds on the positive experiences of jointly governed plans elsewhere in Canada's public sector.

2.3.2.2 Other Post-retirement Benefits: Ottawa promises a variety of other post-retirement benefits to retired employees. The largest are those for disabled veterans of the Canadian Forces and the RCMP, and more generally, for continued employee health and dental coverage after retirement. Other benefits include support for employees who become eligible for workers' compensation benefits, severance benefits, and accumulated sick leave. Ottawa's financial statements put the present value of these benefits at $99 billion as of 31 March 2013 (RGC 2013, p. 2.23).

These obligations are completely unfunded: Ottawa holds no assets to cover the payments when they come due. That they appear in the public accounts at all is commendable – many governments do not record such obligations – but they are buried in the details of net federal debt, and like future pension payments, both their value to federal employees and their cost to taxpayers is larger when interest rates are low.[5]

In 2013, Ottawa began recording the present value of accumulated sick leave entitlements of employees – the estimate of what it would cost to buy back the leave expected to be used in the future. This restatement increased Ottawa's debt by $1.5 billion as at 31 March 2013. Letting employees indefinitely bank unused sick days is practically unheard of in the private sector and increasingly rare in the public sector.[6] This Shadow Budget proposes to eliminate banking of newly earned and unused sick leave entitlements as of 2014/15. This change would save about $300 million per year.

With regard to post-retirement health and dental coverage, the split between pensioners and the government of the monthly premiums is 50-50 under the Pensioners' Dental Services Plan, and

3 Contributions for Group 1 employees of the PS pension plans.

4 Amounts contributed and contribution rates are from plans' actuarial reports (OCA 2011, 2013a, 2013b).

5 Unlike pension obligations, since 2013, obligations and expenses for other future benefits are now recorded and valued at a lower discount rate corresponding to the federal expected long-term bond rate at the valuation date, which in 2013, was higher than the actual yield available on long-term bonds, but less badly out of line than in the case of the pension plans.

6 For example, the government of Ontario has just ended this practice for newly-hired teachers.

25-75 under the Public Service Health Care Plan, the premium for which currently averages about $1,700 per pensioner annually.

There is no case for taxpayers to cover 75 percent of the cost of the Public Service Health Care Plan, especially when such benefits are rare and becoming rarer[7] in the private sector – where the federal government's advantages as a tax-exempt entity are hard to replicate. This Shadow Budget proposes to increase Ottawa's retired employees' share of contributions to the Public Service Health Care Plan to the same 50 percent that applies to the Dental Services Plan, as of fiscal year 2014/15.

This change will cut Ottawa's net debt by about $9.3 billion, amortized over a number of years, with the annual reduction amounting to about $1.3 billion in the near term. It will also lower the net annual cost of new benefits by about $0.5 billion, and reduce debt charges by about $0.3 billion annually. Overall, this change will reduce Ottawa's expenses by about $0.5 billion in 2014/15, and by about $2.1 billion annually for the remainder of our planning horizon.

3 Equipping Canadians for Success

Canada's economic performance is a function of the skills and efforts of workers and the opportunities available to them to deploy their talents. This Shadow Budget takes several steps to improve the outlook for Canada's human capital.

3.1 Less Direct Pressure from Ottawa on Canada's Labour Market

The measures to reduce federal government compensation just described will yield several benefits for Canada's labour market. The improvement to the bottom line – some $1.9 billion to $3.3 billion annually over the planning horizon – creates room for the federal government to lower taxes that discourage work effort. The measures will also ease pressure on employee compensation in the private sector and in provincial and local governments, which will foster private-sector output growth and reduce unemployment.[8]

Alternatively, the federal government can help Canada's labour market by reducing its own employment, freeing up human capital that can be more productively employed elsewhere. After shedding 70,000 jobs during the fiscal consolidation of the 1990s, Ottawa went on a hiring binge after 1999/00 – adding 91,000 jobs to the federal payroll (PBO 2012), which peaked at 380,000 in 2010/11. Initiatives in the last three budgets should reduce this number to 349,000 by 2014/15. This projected level is still much higher than the lowest historical number reached in 1998/99, and still higher than the average of 336,400 for the last 22 years (PBO 2012).

Reducing average compensation per employee is a better way to address the cost of federal employment than numerical targets for public service reductions. Because the reduction in employment costs is so critical to the budget plan,

7 See Globe and Mail, *GM extends pension, health cuts to salaried employees*, Monday August 20, 2012.

8 Alesina et al. (2002) explains the occurrence of fiscal consolidations that led to output growth, such as in Europe during the 1980s, by negative pressure on government employee compensation decreasing relative wages, and therefore increasing business activity and investment. Bermperoglou et al. (2012) found that government wage cuts are the least destructive mean for fiscal adjustments, and that negative government wage shocks can have expansionary effects on output, employment, investment and consumption.

however, the government will resort to reductions in positions to achieve equivalent savings in the event that the measures to rein in compensation fall short of their goal. The government will prepare and review annually a partial hiring freeze that would limit new hires to specified proportions of retirements and departures. Such a freeze would give departments latitude to fill absolutely necessary positions when they become vacant, while reducing the federal government's competition with the private sector and other levels of government for human resources. One way or another, this Shadow Budget aims to achieve substantial compensation savings.

3.2 Skills and Opportunities

Although Canada recovered from the 2008 recession better than most advanced nations, the labour market is still weaker than hoped. Four years after the end of the recession, Canada still has a higher unemployment rate than before, a lower number of people employed as a percentage of the population, and a higher incidence of involuntary part-time work.

The current state of Canada's labour market reinforces the need for policies aimed at improving its efficiency in matching people with jobs, creating new opportunities, stimulating work efforts, and promoting human capital investment through training and education.

The federal government intended the Canada Jobs Grant, announced in principle in the 2013 Budget, to be a centerpiece for the 2014 Budget. Discussions with the provinces over the mechanisms and financing of this initiative are continuing. Meanwhile, this Shadow Budget looks to other measures to help bring workers together with potential employers who can make good use of their talents.

At relatively low cost and within federal competency, Ottawa could dramatically improve Canada's system of labour-market information. It could also make tools like Job Alert and Job Bank much more widely available. It could seek measures to foster labour mobility and reduce mismatches between job vacancies and skills.

In 2009, the Advisory Panel on Labour Market Information – a group established by the Forum of Labour Market Ministers in July 2008 to provide advice on Canada's labour-market information system – released its final report making about 70 specific recommendations classified under 14 broad proposal outlines. Some proposals, such as making Statistics Canada data available free of charge, have been adopted, while others have not. One of those proposals deserving of federal and provincial governments' attention, and requiring their cooperation, would be to improve the educational information collected and made available to current and prospective students – a key example being provision of information about returns to various forms of education enjoyed by today's workers.

The costs of these proposals, at $21 million initially and $49 million annually, are very modest in relation to the potential economic benefits from a better functioning labour market. This Shadow Budget would therefore revisit the Advisory Panel's report with a view to seeing its proposals implemented.

3.3 Shifting the Taxation Base from Personal Income to Consumption

Taxes change the relative prices and rewards of various economic activities, distorting their supply. A well-structured tax system finances the desired level of public spending with low distortionary costs to the economy and society.

High personal income tax rates discourage work, saving, and investments in training and education. When it comes to the mix of taxes on personal income, sales, corporate profits, and business capital, it is widely recognized that capital and income taxes are more directly discouraging of productive activity in that they are likelier to

induce relocation, avoidance and evasion, than are broad-based consumption taxes.[9] This is especially true when income taxes weigh heavily as a source of government revenues.

Among the labour-market groups most responsive to high taxes are second earners in families with children, lone-parent mothers, and older workers. While the responsiveness of overall labour supply to income tax changes is a matter of debate, studies generally find these three groups to be more responsive to high taxes, especially in their labour-market participation. These groups, moreover, tend to have relatively high marginal effective tax rates at lower income levels due to Canada's extensive system of income-tested transfer payments (Laurin and Poschmann 2013, 2011).[10]

High-income earners also tend to respond to tax rates more than other earners. These reactions come in a number of forms: work effort, source and the timing of declared income, avoidance and evasion (Saez et al., 2012). A recent Finance Canada study (Canada 2010) estimates that the top 10 percent of earners – those who reported $60,000 or more – respond to a 1 percent change in their after-tax income at the margin with a change of 0.19 percent in their taxable income.[11] The top 1 percent of earners – those who reported $150,000 or more – are nearly four times as sensitive, with a response of 0.72.

Shifting the tax mix toward less problematic consumption taxes would encourage greater labour force participation and work effort, and personal investment in human capital. This Shadow Budget proposes a revenue-neutral tax point transfer from the personal income tax (PIT) to consumption by reducing all federal PIT rates by 1 percent and raising the GST rate by an equivalent 1 percent.

A static calculation suggests that this shift will be cost-neutral for the federal government (Laurin and Robson 2013, Table 5). The stimulative effect of lower income taxes on taxable income, however, means that more economic activity can be expected over time, bringing in an additional $900 million of federal revenue annually. The government could address distributional concerns about raising consumption taxes while cutting income taxes by using some of this money to enhance the GST credit or the Working Income Tax Benefit, or to further reduce the tax rate on low-income earners. We therefore show this change as being revenue-neutral for the federal government.

The growth-enhancing impact will also produce about $800 million per year of additional revenues for provincial governments (Laurin and Robson 2013, Table 5) – amounts they can use to accelerate their own fiscal consolidations, without further damaging increases to either personal or business tax rates. These extra revenues will also serve to reduce or forestall increases to corporate tax rates, which would preserve a virtuous circle of federal and provincial tax reductions that improves the fiscal situation of both levels of government.

9 Levying income and consumption taxes on broad bases at similar rates would create similar disincentives, since people earn income in order to spend it, making the two types of taxes similar on a life-cycle basis. As a practical matter, however, empirical studies have demonstrated higher and more significant behavioural impacts to changes to income taxes than to consumption taxes. This could be due to income taxes applying to more confined bases or the relative underutilization of consumption taxes relative to income taxes.

10 For low-income individuals in these groups, earning extra income can trigger clawbacks of transfer payments, leading to a high effective tax rate on each extra dollar earned, and thus potentially discouraging extra work effort or labour force participation.

11 After tax income in this context is the individual's net-of-tax rate – one minus his or her marginal tax rate.

3.4 Eliminating Regionally Differentiated EI

The existing EI program has encouraged dependency for many workers and discouraged migration to areas where job prospects are brighter (Busby et al. 2009). Longer benefit payout periods in areas with higher unemployment rates perpetuate seasonal and structural unemployment, providing incentives for people to remain in places where job prospects are relatively poor.

This Shadow Budget proposes phasing out regionally differentiated entrance requirements and benefit periods and adopt coast-to-coast uniform requirements, tied to the national unemployment rate to add a countercyclical income stabilization element to the program (Busby et al. 2009). Uniform national entrance requirements and benefit periods could be phased in over a few years: low-unemployment regions and high-unemployment regions would see their requirements converge to a uniform national mid-point.

In the short term, the reform may lead to transitional costs, as the number of laid-off workers in low-unemployment regions gaining in terms of access and benefit generosity may outnumber others from high-unemployment regions. Over the long run, however, the fiscal costs of this reform should be close to nil because more generous benefits in some regions should be offset by falling costs of periodic claimants in others, as well as increased labour mobility reducing the incidence of structural unemployment. We budget an annual transitional cost of $0.4 billion in 2014/15 and $0.3 billion in 2015/16.

3.5 Increasing the Cut-Off Age for Tax-deferred Retirement Saving

Life expectancy in Canada has been increasing by roughly two years per decade since the 1960s, but current age limits related to retirement do not adequately reflect this change. Canadians and their employers must stop contributing to tax-deferred retirement saving vehicles at age 71, also the age at which users of these vehicles must start drawing down their wealth.

We propose to increase the age at which contributions to tax-deferred retirement saving vehicles must end to 72 on 1 January 2015, and begin increasing it by one month for every six-month interval after that. Among other advantages, this change could promote later retirement.

4 Promoting Savings and Investment

Investment in plant and equipment per worker by business in Canada has long lagged that in the United States and other major developed countries, likely contributing to disappointing productivity growth in Canada. Although relative performance since the 2008 financial crisis has been better, Canada's improved standing largely reflects weakness elsewhere, and strong investments in resource-rich provinces rather than robustness across the country. Central Canada's record has been poor: for every dollar of new plant and equipment enjoyed by the average US worker from 2007 to 2011, the average Ontario worker got about 67 cents and the average Quebec worker 63 cents (Dachis and Robson 2013).

Since the crisis, moreover, Canada has become strongly dependent on foreign saving to finance its consumption and investment. Households have been chronic net borrowers since the beginning of the 2000s, and with governments plunging into deficit after 2008, a national shortage of saving is evident in large foreign capital inflows – averaging nearly $70 billion at an annual rate since the beginning of 2012.

Along with the fiscal consolidation that will ease the federal government's own claims on national saving, this Shadow Budget proposes other measures to promote investment and the private sector saving that can finance it.

4.1 Removing Federal Payroll Taxes from Employer Contributions to Group RRSPs

Group RRSPs currently have tax disadvantages compared to defined-contribution pension plans and pooled registered pension plans (PRPPs). Sponsors and/or participants should be able to deduct some administrative expenses currently levied against plan assets from outside income, and federal payroll taxes should not apply on employer contributions, which are likelier than employee contributions to be locked in (Robson 2010). The Shadow Budget would implement these changes, which will have very small impacts on federal revenue during the projection period, but will help to alleviate what is currently a severe disadvantage for most private-sector retirement savers as opposed to their public-sector counterparts, and ensure that more of households' foregone consumption ends up in wealth rather than government coffers.

4.2 Eliminating the Age Schedule of Mandatory Withdrawal for RRIFs

Increasing longevity means that ensuring people do not outlive their retirement savings is a continuing challenge. Often at retirement, and no later than the end of the year they reach age 71, people with capital accumulation plans (CAPs) must annuitize or put their funds into a registered retirement income fund (RRIF). The *Income Tax Act* obliges RRIF holders to withdraw funds at a prescribed pace. Since 1992, they have required a minimum of 4 percent of the beginning-of-year balance at age 65, then escalating until, from 94 onward, holders must withdraw 20 percent of their balances each year (Robson 2008).

While RRIF holders can reinvest some of these obligatory withdrawals in TFSAs, not all will have the necessary TFSA contribution room, and the need to transfer funds creates unnecessary costs and risks. Based on new longevity tables and a portfolio of government bonds of various maturities, retirees turning 65 and converting their retirement savings into a RRIF are likely to exhaust more than three-quarters of their RRIF savings by the date of their average life expectancy, and have a more than 25 percent chance of exhausting the bulk of their RRIF savings before they die.

We propose to eliminate prescribed minimum withdrawal requirements from RRIFs, to ensure seniors are not forced to prematurely exhaust their RRIF savings and are not artificially discouraged from keeping a cushion to pay for long-term care needs if they happen to live longer than average. These changes would only alter the timing of income taxes collected on contributions and withdrawals, and thus would have a very limited fiscal cost over a longer time horizon.

4.3 Extending Pre-age-65 Eligibility for Pension Income Credits and Income Splitting

At present, the Pension Income Tax Credit and pension income splitting are available to recipients of pension annuities before age 65, but only at age 65 to recipients of funds from other retirement saving vehicles, such as life income funds, Registered Retirement Income Funds (RRIFs) and RRSPs. This Shadow Budget proposes to make these tax provisions available to all such income, regardless of age.

4.4 Exempting from Taxation Interest Payments Received from Active Business Income of Foreign Affiliates

Financial innovation is blurring the traditional distinction between corporate debt and equity. Hybrid instruments, treated as debt in one country and equity in another, let businesses reduce tax burdens on cross-border investments. One popular hybrid exists in Luxembourg, where the stock of Canadian foreign direct investment exploded from $0.3 billion in 2005 to $19.7 billion in 2012. The cost and administrative burden of establishing

and running foreign financing companies absorb resources that could be deployed more productively in Canada.

A Canadian company should be able to elect dividend treatment on interest payments paid out of exempt surplus and received from its foreign affiliates. Exempting from tax not just dividends but also interest payments paid by foreign affiliates – as suggested by the Advisory Panel on Canada's System of International Taxation in 2008 – would reduce the impact of tax considerations on business investment decisions.

4.5 Establishing an Ongoing Rolling Review of Capital Consumption Allowances

Ensuring that businesses can write assets down for tax purposes over the period that corresponds to their economic lives helps avoid tax-driven distortions in investment. It is also an ongoing challenge, since many factors – notably changes in technology – can make past assumptions about the life of assets obsolete.

Since the mid-2000s, the federal government has made fresh efforts to ensure that CCA rates correspond to economic lives of assets, and discussions with interested parties and experts are continuing. This Shadow Budget commits to a formal rolling review of various asset categories, intended to ensure that the categorization of assets in classes are up to date, and that the write-off periods for each class are also up to date. The government will post a schedule for reviewing each asset class in April 2014.

5 Innovation and Entrepreneurship

As Canada's population ages, its labour force will grow more slowly and the capital stock will likely grow more slowly as well. Productivity improvements will be all the more important to raise private incomes and governments' tax bases. A better "supply" system affecting innovation and commercialization can help. Also vital is an environment that fosters demand for innovation – openness to the world, competitive pressures, and efficient public services.

5.1 Improving the Tax Treatment of Intellectual Property Income

Canada enjoys too little business investment in innovative processes, as evidenced by Canada's low rate of growth in patent registrations and low rates of commercialization of new products and services vis-à-vis other member countries of the Organisation for Economic Co-operation and Development and developing economies such as Brazil, China, and India. One way to address this deficiency is through an "Innovation Box" approach to encourage investment in innovation that improves productivity, growth, and incomes.

Over the last 30 years, the number of Canadian patents transferred to a foreign country, as a share of Canadian patents granted or applied for, has increased steadily. This may be due to a more favourable economic environment in other countries, which means an increasing number of patents exploited elsewhere for ordinary business reasons. However, the pattern of destination countries for Canadian patents show that other factors are also at play, "such as the decision of a corporate group to structure affiliates so as to receive patent licence or royalty income in favourable tax jurisdictions" (Pantaleo et al. 2013).

Several countries have introduced, in particular, a tax regime known as a patent box designed to reduce the normal corporate tax rate for income derived from patents and, potentially, other income derived from intellectual property. There is a strong case for considering a similar preferential regime in Canada to support research and development spending by encouraging the adoption, commercialization and use of innovative ideas.

This Shadow Budget would adopt a new incentive model for R&D, known as an "innovation box," as was suggested by Pantaleo et al. (2013).

Under this suggestion, businesses could "receive less tax relief for conducting R&D, and more for adopting, commercializing, or otherwise exploiting the output of the R&D process – in short, a pull, rather than a push, into R&D activity." A reduced corporate income tax rate would apply to qualifying income derived from R&D conducted in Canada. Integrating current SR&ED tax incentives when computing qualifying income would limit the fiscal cost of the innovation box. The annual revenue cost from this initiative is estimated to be approximately $1.0 billion beginning in 2015/16.

5.2 Emphasize Academic Excellence in Supporting Research

Canada continues to struggle with the challenge of transforming academic research into commercial success. Promoting research, and encouraging development and commercialization of promising innovations, requires attention to the different incentives that affect various participants in the chain of value creation.

At the research end, this Shadow Budget proceeds on the assumption that the best way to attract the top scientists to Canada is to redirect research support towards the problems that are most challenging from a scientific point of view, not towards those that bureaucrats view as most likely to lead to commercial success. Following Howitt (2013), this Shadow Budget proposes to reorient federal granting agencies supporting academic research to give more weight to overall academic excellence rather than immediate practical payoff. Such a reorientation will provide incentives for universities to provide a rich environment that attracts top scientists and engineers and researchers – an approach also likelier to attract private-sector support than one driven by government attempts to pick winners.

Complementary to this change will be a further evolution of the National Research Council to a pan-Canadian technology transfer institution rather than a provider of federal funding for research. This transformation will see the National Research Council more actively engaging university researchers as partners rather than in-house research.

5.3 Scaling Back Financial Assistance to Crown Corporations

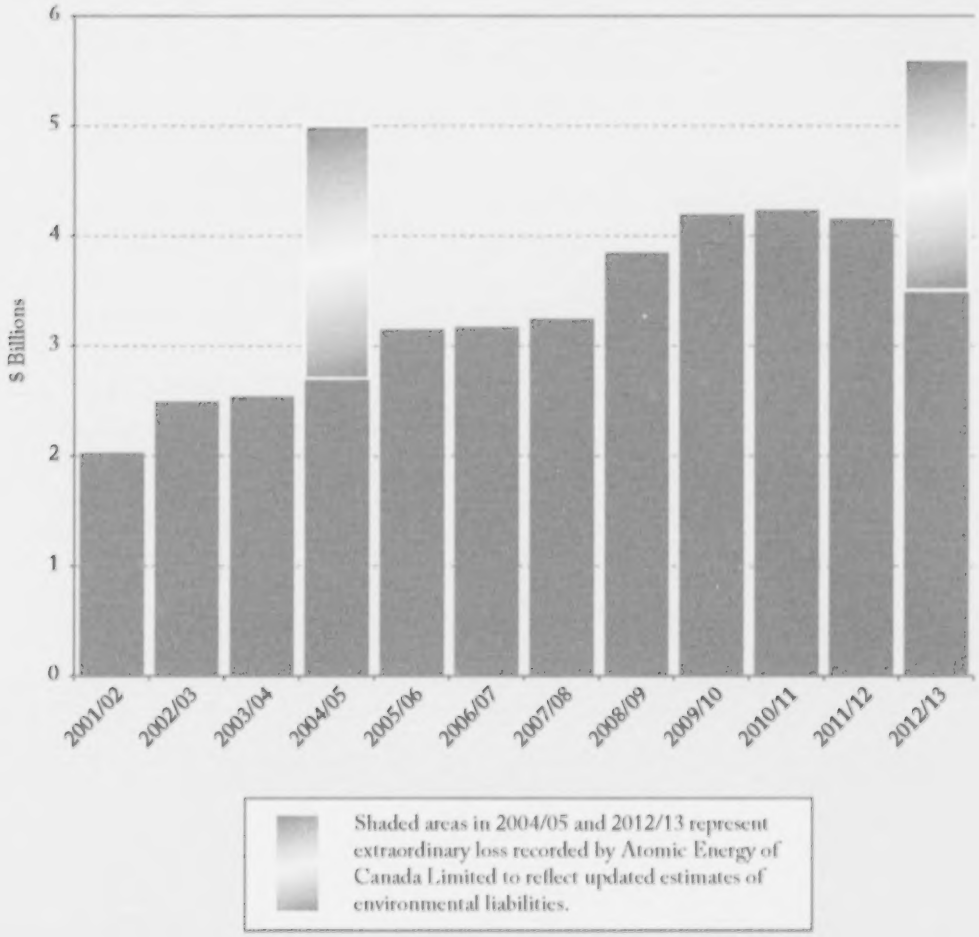
Crown corporations, such as the Canadian Broadcasting Corporation, Atomic Energy of Canada Limited, and VIA Rail rely on annual funding from the government to support their regular activities, and financial assistance to them (excluding extraordinary charges related to environmental liability updates) rose steadily from 2001/02 to 2009/10, before starting to decline in 2012/13 (Figure 3). The need to operate in a commercial environment means that they must return, individually and collectively, to a sustainable position rather than perpetually drawing on public funds.

The 2012 departmental program review exercise aimed to reduce spending on Crown corporations by more than $250 million per year by 2014/15. The longer-term goal, however, should be to put all federal Crown corporations on a self-sufficient basis for all of their market-oriented activities. This Shadow Budget therefore initiates a three-year phase-out of half of Crown corporation net subsidies. This reduction would leave the overall level of Crown corporation subsidies around where it was in the early 2000s, and yield additional savings during the projection period of $1.1 billion in 2014/15 and $1.2 billion in 2015/16.

5.4 Preparing Canada Post for a Commercial Future

Canada Post, a Crown corporation, is facing a future of large financial losses due to mounting pension obligations, declining volumes of the traditional mail in which it has a protected market, and costly universal service commitments. These losses will affect taxpayers, and the recent announcements from Canada Post that it will

Figure 3: Net Federal Subsidies to Crown Corporations, 2001/02 to 2012/13



Note: Amounts represent third-party expenditures net of third-party revenues for Crown corporations whose financial statements are consolidated with the annual financial results of the government.

Source: Public Accounts of Canada, various years.

hike the prices of its traditional mail service while cutting service offer no hope of reversing the company's decline. This Shadow Budget proposes to reposition Canada Post as a vigorous competitor in a rapidly changing network industry.

The centerpiece of the repositioning is an end to the protected Lettermail class: any competitor will be permitted to deliver first-class mail at any price after 1 January 2015. This change will allow entrepreneurs and established companies to

supplement the mail service in areas where Canada Post currently delivers only to centralized locations. Canada Post's universal service obligation will be phased out as well, with any qualified company – including Canada Post – bidding for contracts to service rural and remote customers (Dachis 2013). This change will let Canada Post compete more vigorously in areas it manages relatively well, notably parcels, while making the subsidy to hard-to-service areas explicit and easier to manage.

Canada Post has a $6 billion unfunded pension liability, which will be a formidable obstacle to its viability in a competitive market. This Shadow Budget proposes that the federal government fund one-half of this amount – consistent with a 50-50 cost-sharing model prevalent in many public-sector pension schemes – issuing an additional amount of real-return bonds to raise the necessary funds. This will increase federal market debt in fiscal 2014/15; the counterpart to this assistance, however, will be an immediate cessation of further loans, investments and advances to Canada Post, insulating taxpayers from any additional losses as the company transitions to a commercial environment.

5.5 Financial-Sector Crowns

Among other Crown corporations that are self-sufficient and thus do not rely on government funding as a source of revenue, are three Crown corporations operating in the financial sector: the Business Development Bank of Canada (BDC), Export Development Canada (EDC) and Farm Credit Canada (FCC). These Crowns typically had their origins in a perceived lack of credit – a credit market gap – for some consumers and businesses. Their existence is justified by their ability to redress such real or perceived credit market failures. They receive financial assistance from the government primarily through their lower cost of capital – they can borrow at government rates, they do not go to market for relatively expensive equity, and they are not exposed to the corporation income tax.

However, the economic context has evolved since their inception, and private institutions today can serve many of the perceived market gaps that the Crowns were created to serve. Because they are expected to be financially self-supporting, returning a "dividend" to taxpayers, financial Crowns have revenue-generating objectives that put them in competition with private institutions in a variety of ways. But therein lies a contradiction: "the more profitable the corporation, other things being equal, the less convincing is the argument that private enterprise would fail to provide the same goods or services." Even if market gaps existed, "…the presence of a dominant Crown will deter competitive market entry and product and service innovation. From this perspective, the existence of a Crown tends to ensure the persistence of the market gap it might have been intended to fill" (Bergevin and Poschmann 2013).

Following the recommendations of Bergevin and Poschmann (2013), this Shadow Budget would ensure that financial Crowns have a clearly articulated mandate complementary to private institutions, the extent of which would be clearly disclosed in annual reports. This requirement is particularly relevant to FCC, given that it has no legislative requirement whatsoever to be complementary. The complementarity mandates of all Crown financial corporations should also be better defined in guidelines and, more importantly, be better reflected in practice. For example, financial Crowns should access government funding at commercial market rates, or alternatively should adopt a lending threshold of prime business rates plus 300 basis points, below which the Crowns would not offer financing. Finally, all Crowns would be regulated by OSFI, be reviewed regularly, and be subject to sunset clauses in their legislation (such as the *Bank Act*).

5.6 Reducing Tariffs

Since 1974, Canada has provided preferential access to its markets through a general preferential

tariff (GPT) program, which eliminates tariffs on some $15 billion per year of imports into Canada. Beginning in 2015, a number of countries that have become large, globally competitive exporters and/or have reached middle-income status, will no longer receive these preferences.

The links between openness to the world and prosperity are well known, and evident throughout Canadian history. Any increase in revenue resulting from the removal of certain countries from GPT status should be effectively returned to consumers in the form of lower across-the-board MFN tariffs, for a cost of about $0.3 billion annually. Countries affected have, or will have in the fullness of time, the opportunity to eliminate tariffs by engaging in free trade negotiations with Canada or through multilateral negotiations.

5.7 Review of Tax Expenditures

Canada's tax system contains many provisions giving certain taxpayers preferential treatment related to particular circumstances or behaviour. These preferences come in many forms: deductions, exemptions, credits, rebates and deferrals. They are commonly labeled "tax expenditures" since they make government revenue lower than it would otherwise be, and serve purposes that could and in many cases arguably should be served by spending programs.

Many tax expenditure provisions are functionally equivalent to direct program expenditures, yet they are rarely scrutinized by Parliament and the government for their cost-effectiveness at meeting their stated objectives. Unlike tax preferences that define the tax base, and respond to such considerations as ability to pay and practicality,[12] many preferences are designed to change behaviour by promoting, facilitating, or indirectly financing individual or business activity – objectives that are at least equally, and arguably more appropriately, served by explicit spending programs.

The federal arts, fitness and transit credits just mentioned are recent additions to dozens of provisions ranging from the employee stock option deduction, meant to assist businesses in their efforts to attract and retain highly skilled employees, to the Atlantic Investment Tax Credit, aimed to promote regional economic development. Such provisions often appear to the taxpayers involved to be exactly like granting programs, and ordinary spending programs could achieve the same objectives. Restating these provisions to show federal revenue and spending gross of these amounts would increase the size of the federal government by 18 percent, representing more than 2.5 percent of GDP (Laurin and Robson, Forthcoming).

The federal government has in recent years restated its budgets to make some programs that were previously netted against revenue, such as the Canada Child Tax Benefit, visible as spending. These additional restatements will promote more adjustments to make such provisions easier for legislators and citizens to see. That visibility should foster closer and more systematic review of these programs to ensure they are meeting their policy objectives and that Canadians are getting enough bang for the bucks they previously did not know they were spending. Tax expenditure provisions that are equivalent to spending should be reviewed and evaluated with the same rigour devoted to program expenses. The government will submit its proposals for these additional restatements to the Standing Committee on Public Accounts of

12 Preferences that reflect such considerations as age, children, or disability are important, because they lead to higher tax rates on taxable income for a given level of spending. Laurin and Robson (Forthcoming) find that these provisions shift taxes equal to about 5 percentage points on the lowest personal income tax rate, and 1.5 percentage points on the GST rate.

Table 3: Fiscal Projections with Shadow Budget Initiatives			
	2013/14	2014/15	2015/16
		($ billion)	
Baseline Projections (Table 1)			
Projected Revenues	254.3	267.9	284.3
Projected Expenditures	-270.7	-270.3	-277.6
Adjustment for Fiscal Prudence	-1.5	-3.0	-3.0
Budgetary Balance before Initiatives	**-17.9**	**-5.5**	**3.7**
Shadow Budget Initiatives			
Cap Ottawa's Employee Pensions' Contribution Rate		-1.1	-0.9
Terminate indefinite carry over of sick leave entitlements		-0.3	-0.3
Move to 50/50 pensioner/employer cost sharing of Public Service Health Care Plan		-0.5	-2.1
Better Labour Market Intelligence		0.1	0.1
Shifting the Taxation Base from Personal Income to Consumption		-	-
Eliminating Regionally Differentiated EI		0.4	0.3
Increasing the age at which contributions to tax-deferred retirement saving vehicles must stop			0.1
Removing federal payroll taxes from employer contributions to group RRSPs		0.1	0.1
Exempting from taxation interest payments received from active business income of foreign affiliates		0.2	0.2
Adjusting the age schedule of mandatory withdrawal for RRIFs		-	-
Expand eligibility to the pension income tax credit and pension income splitting		0.1	0.1
Improving the Tax Treatment of Intellectual Property Income		-	1.0
Increase emphasis on academic excellence in university grants		-	-
Scaling back financial assistance to Crown Corporations		-1.1	-1.2
Reposition Canada Post and fund one-half of the pension liability with real return bonds		-	0.1
Reducing tariffs		0.3	0.3
Review of Tax Expenditures		-	-
Total		**-1.8**	**-2.2**
New Budgetary Balance	**-17.9**	**-3.7**	**5.9**
Accumulated Deficit	617.9	621.6	615.7
as % of GDP	*33.0*	*31.8*	*30.1*

Sources: Table 1 above; authors' calculations.

the House of Commons, and intends to provide the Committee with an annual report to assist its scrutiny of programs currently delivered through the tax system.

6 Pulling It Together

The plan for equipping Canadians for success, as outlined in this section, would be cost-effective, leaving $5.9 billion in 2015/16 to pay down the debt (Table 3). The economic contribution from these growth-oriented measures in the years ahead will lead to further improvements in the bottom line, leaving more fiscal room for federal tax reductions and financing of healthcare delivery at the provincial level.

Despite continuing economic challenges, then, this Shadow Budget builds on Canada's relatively good position by reinforcing the near-term progress toward budget surpluses, and promoting economic growth in the longer term. It will leave Canadians better protected from higher interest rates and unnecessarily high costs of delivering federal government services. It also improves the outlook for Canadian workers, with measures to better deploy human capital, promote capital investment, and income-boosting innovation. It is the kind of fiscal leadership Canadians need from their federal government.

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